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No. 1339

Supreme Court of the United States

October Term—1946

HELEN A. DEGUIRE, as Executrix of the Last Will and Testament of George N. DeGuire, deceased,

Petitioner,

—against—

JOSEPH T. HIGGINS, Collector of Internal Revenue of the United States for the Third District of New York,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

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HELEN A. DEGUIRE, as Executrix of the Last Will and Testament of George N. DeGuire, deceased,

Petitioner,

—against—

JOSEPH T. HIGGINS, Collector of Internal Revenue of the United States for the Third District of New York,

Respondent.

PETITION FOR WRIT OF CERTIORARI

To the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petition of Helen A. DeGuire respectfully shows to this Honorable Court:

Summary Statement of Matter Involved

In this action to recover income taxes unlawfully collected, the petitioner seeks to review on writ of certiorari a decision of the United States Circuit Court of Appeals for the Second Circuit, rendered on February 11, 1947, which reversed a judgment of the United States District Court for the Southern District of New York in favor of the petitioner and dismissed the complaint. The opinion of the District Court is reported in 65 F. Supp. 445 (R. p. 123), that of the Circuit Court in 159 F. 2d 921 (R. p. 134). The District Court awarded judgment to petitioner for $45,-

452.61, the full amount demanded in the complaint, with interest and costs (123, 128).

The action was brought by petitioner to recover from respondent, Collector of Internal Revenue, the sum of $45,-452.61 with interest upon the ground that said amount had been erroneously and illegally assessed and collected by respondent as an alleged deficiency in income taxes of petitioner's testator, George N. DeGuire, for the years 1936 and 1937 (2-12).

The essential facts have been stipulated in writing by the parties (24-34). The facts are also summarized in the main opinion of the Circuit Court, written by L. Hand, *Circuit Judge* (135-137). It would serve no useful purpose to repeat the facts here again in detail. It is important, however, to note that the case hinges upon the agreement, dated December 31, 1935 (12-18), to which petitioner's deceased husband, together with Fay Harvey Moore and Charles H. Bosworth were parties and that, under that agreement, petitioner's testator became the holder of an option to purchase stock in the Ajax Hand Brake Company. A substantial payment was made on the execution of the agreement by the buyer, DeGuire, and the stock certificates were attached to interest bearing "notes" of the buyer and deposited with a bank in escrow. The buyer assumed no liability on the so-called "notes" (16-18). If they were not paid when due, the stock was to be returned to the seller and, if paid, the stock was to be delivered to the buyer. The agreement concluded with the following provisions:

> "All dividends which may be paid, during the life of this agreement, on the stock of the Ajax Hand Brake Company agreed hereby to be sold, shall be credited by the recipient thereof upon the principal and interest of the next one of the said notes thereafter to become due.

> It is understood and agreed that the party of the third part (DeGuire) shall not be personally liable under this agreement or otherwise or upon any of said notes, and that the only remedy of the parties of the first and second parts in the event of the failure of the party of the third part (DeGuire) to pay any of said notes and accruing interest thereon, shall be the right to the re-delivery of the certificate or certificates of stock attached thereto" (16-18).

Dividends for the years 1936 and 1937 were declared and were paid in accordance with the agreement.

The principal issue arises under the internal revenue laws. The question is a substantial one upon which many conflicting opinions have been written in the lower courts. Simply stated, the question is whether interim dividends on stock deposited in escrow are taxable as income to the record owner of the stock or to the holder of an option to purchase the stock.

The answer to this question depends upon the proper legal construction of the agreement entered into by petitioner's testator for the purchase of certain shares of stock which, when fully executed, gave petitioner's testator almost complete ownership of the Ajax Hand Brake Company (12, duplicated at 38).

The very same agreement, passed on by the courts below, has been in evidence before other courts and has been construed in other proceedings (*Fay Harvey Moore* v. *Commissioner of Internal Revenue,* 42 B. T. A. 949; reversed 124 F. 2d 991, C. C. A. 7th, 11/26/41; *Fay Harvey Moore* v. *George N. DeGuire,* 125 F. 2d 486, C. C. A. 2nd, 1/15/42).

The main issue in this case is whether, under that agreement, the dividends actually paid on the stock to the sellers during the life of the agreement, in the tax years 1936 and

1937, constituted taxable income to petitioner's testator, the purchaser under said agreement. With respect to the alleged claim for a deficiency tax for the year 1936, the petitioner also raises the Statute of Limitations. Except for the issue raised by the Statute of Limitations, the petitioner's claim as to 1937 is the same as for 1936.

The Commissioner of Internal Revenue originally assessed the income tax on the dividends against the seller, Mrs. Fay Harvey Moore as the owner of the stock. This assessment was upheld by the Board of Tax Appeals, two members dissenting (42 B. T. A. 949). Thereupon Mrs. Moore appealed to the Circuit Court of Appeals for the Seventh Circuit on November 26, 1941. The Seventh Circuit Court reversed the Board of Tax Appeals by a two to one decision (124 F. 2d 991). That case ended in the Circuit Court, the government having made no attempt to obtain a review by this Court. The petitioner here was not bound by the majority ruling of the Seventh Circuit Court. DeGuire was not a party to that case; although he did apply for leave to intervene, his application was denied.

Following the decision of the Seventh Circuit Court relieving Mrs. Moore from the income tax on these dividends, the Commissioner assessed the tax against petitioner's testator and the tax was paid under protest. This action was then brought to recover the sums thus paid. In granting judgment in favor of the petitioner, the District Court decreed that the tax was illegally assessed and collected, the Court holding that the application of the dividends in reduction of the purchase price effected merely a reduction in the cost basis of the stock to petitioner's testator (126). The Second Circuit Court of Appeals rejected this theory and reversed the District Court holding that

the taxes on the dividends were properly assessed against petitioner's testator.

The same agreement to sell, on January 15, 1942, had been construed by the Second Circuit Court in *Fay Harvey Moore* v. *George N. DeGuire* (125 F. 2d 486), in reviewing and affirming a judgment denying rescission of the agreement to Mrs. Moore. There have been, therefore, three separate reviews of this agreement by Circuit Courts of Appeals, one review in the Seventh Circuit and two reviews in the Second Circuit.

The majority opinion in the Seventh Circuit Court (124 F. 2d 991) reversed the finding of the Board of Tax Appeals that, under the agreement, the buyer was an optionee only and held that title to the stock passed to the buyer upon the execution of the contract. It further held that even if title remained in the seller, the buyer had the beneficial use of the dividends and they were taxable as income to him. A vigorous dissent was recorded by Judge Evans who held that the agreement gave the buyer an option only and that the dividends were taxable to Mrs. Moore (p. 994).

The Circuit Court of Appeals for the Second Circuit, in the instant case, disregarded the question of ownership of the stock and found it unnecessary to pass upon this point although the Court expressly states that DeGuire "* * * did not become in any sense the owner of the shares except as he exercised his options" in the years 1936 and 1937 (138). Judge Clarke, in his concurring opinion, stated that, for tax purposes, we should look to practicalities and disregard merely formal and not useful rights and pierce such general abstractions as "option", and concluded that petitioner's testator had the greater number of attributes of ownership (142).

The Second Circuit Court had previously held in *Moore* v. *DeGuire* (125 F. 2d 486) that the effect of the agreement

was to give the buyer an option. This latter decision was made two months after the decision in *Moore* v. *Commissioner* in the Seventh Circuit Court (124 F. 2d 991), and the conclusion is inescapable that the Court adopted the view expressed in the dissent of Judge Evans. Yet, when the instant case came before the Second Circuit Court, that Court held that even though title remained in the seller, the beneficial use of the dividends was in the buyer and, hence, were taxable to him.

This enunciation of a doctrine which permits a severance of the fruit from the tree has very dangerous implications in income tax law and will, undoubtedly, have far reaching effects. The severance of income from ownership, which finds approval in these opinions, opens the door to the possible shifting of tax liability which can only be shut by an authoritative statement from this Court. When the enjoyment of the income can be set apart from the ownership from which it springs, we have such a radical departure from established concepts of taxation that the final word should issue from this tribunal.

Petitioner contends that the dividend payable, and actually paid, to the owner of the stock is taxable as income to the owner and not to the holder of the option. Under the agreement in this case, the credit of the dividend on account of the purchase price of the stock was but a reflection of the decrease in the surplus of the corporation which was part of what petitioner's testator was purchasing by acquiring the stock. The application of the dividend in reduction of the purchase price was, to him, a reduction in the cost basis of the stock and would be reflected in the fixation of the capital gain or loss upon ultimate disposition of the stock.

The error of the Circuit Court of Appeals for the Seventh Circuit, uncorrected because not appealed to this Court, should not be perpetuated on the theory that "the dividends

were earnings upon the shares and were inexorably someone's income" (Circuit Court Opinion, R. p. 139); that since the income tax was not collected from Mrs. Moore, it must be collected from petitioner's testator's estate. If "we should look to practicalities" (Concurring opinion Clark, *J.*, p. 142), and be "not as much concerned with refinements of title as * * * with actual command over the property taxed—the actual benefit for which the tax is paid" (*Corliss* v. *Bowers*, 281 U. S. 376, 378, quoted in *Griffiths* v. *Commissioner*, 308 U. S. 355-357), and strip the transaction to its bare essentials, we find that petitioner's testator undertook, without being obligated to do so, to buy stock of a corporation at a price based on the then capital and surplus of the company including good will. For this option, he paid a substantial amount, the tax status of which, in the hands of the recipient, was in suspense. If he failed to exercise the option, the initial payment would become income to the recipient in the year the option expired without being exercised. If he exercised the option, it would become, to the recipient, the return of capital. When the dividend was declared on the optioned stock, the funds with which the dividend was paid were converted from a capital asset of the corporation to income to the owner of the stock and, to the extent of the dividends declared, the value of the stock was reduced. When finally the optionee exercised his option, he received stock which had been depleted in value to the extent of the dividends declared, such depletion being reflected in a decreased cost to him.

That, in reality, is the effect of the agreement. The net effect of the decision below, however, is to charge petitioner's testator with the income tax on dividends which were paid to another as owner of the property, and over which petitioner's testator never had any control, when, in fact, under the agreement to sell, the dividends declared

during the life of the option agreement were to affect the purchaser only by effecting a downward adjustment in the purchase price of the stock.

A question of lesser importance is also involved in this application, namely, whether the five or three year Statute of Limitations applies. It is the contention of the Collector that petitioner's testator omitted from gross income an amount in excess of twenty-five percent of the gross income stated in the return for the tax year 1936 and, therefore, the five year Statute of Limitations applies. This is correct only if the dividends were taxable to the buyer *precisely* as dividends. If, however, an income tax is to be assessed against petitioner's testator solely upon some theory of economic benefit flowing from the agreement, the agreement must be taken as a whole and the burdens which the agreement imposed must be set off against the benefits received and only the net benefit is reportable and subjected to tax. This is readily fixed by mathematical computation, for the dividends paid during the year 1936 amounted to $34,895. From this sum should be deducted the interest paid in 1936 on the unpaid balance of the purchase price amounting to $3,498.36, leaving a "net benefit" to be returned as taxable income of $31,396.64. If the income tax is to be assessed against the "net benefit" only, the tax will be assessed against a sum which is less than twenty-five percent of the gross income stated in the return and the three year Statute of Limitations would bar the collection of the tax.

Jurisdiction

The jurisdiction of this Court is invoked under section 240 (a) of the Judicial Code (28 U. S. C. A., sec. 347 (a)).

The Questions Presented

1. Are dividends paid on stock deposited in escrow under an option agreement taxable as income to the owner of the stock or to the optionee?

2. If taxable as income on any theory of economic benefit arising from the agreement, should the burdens of the contract be offset against the benefit and the tax apply to the net benefit only?

Reasons Relied on for the Allowance of the Writ

Until the decision in this case, it had uniformly been held that the dividends on stock deposited in escrow were taxable to the owner. (*George R. Myers,* 42 B. T. A. 640 [1940]; *Max Viault,* 36 B. T. A. 430 [1937]; see I. T. 1958 III-1 Cum Bull. 111 [1924].) Even the decision of the Circuit Court of Appeals for the Seventh Circuit in *Moore* v. *Commissioner,* 124 F. 2d 991, is consonant with this uniform rule, for the majority there held that title to the stock had passed to the buyer upon execution of the agreement. However, the majority did indicate a departure from the established rule when it stated that even if title had not passed, the buyer had the beneficial use of the dividend. The break was completed with the decision sought to be reviewed.

In *Griffiths* v. *Commissioner,* 308 U. S. 355, 357, this Court said:

> "Taxes cannot be escaped 'by anticipatory arrangements and contracts however skillfully devised * * * by which the fruits are attributed to a different tree from that on which they grew.' *Lucas* v. *Earl,* 281 U. S. 111, 115."

The decision of the Circuit Court permits that severence and is an open invitation to transfer income which would normally fall in the highest tax brackets to the lowest. The danger is apparent as noted in Harvard Law Review, LIX, 8 (October 1946), 1292 at p. 1298:

> "And the possibility of using the device to avoid taxation of income to the owner of the income-producing property would also seem to justify taxation to the seller."

The decision of the Circuit Court of Appeals for the Second Circuit should be reviewed not only so that an injustice shall not be done to this petitioner but also to correct a most dangerous precedent which would permit the siphoning of income from the top layers to the low, a result which will inevitably follow if the decision of the Circuit Court is permitted to stand.

WHEREFORE your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this honorable Court, directed to the United States Circuit Court of Appeals for the Second Circuit, commanding that Court to certify and to send to this Court, for its review and determination, on a day certain to be named therein, a full and complete transcript of the record and all proceedings in the case numbered and entitled on its docket No. 150, October Term, 1946, *Helen A. DeGuire as Executrix, Appellee,* v. *Joseph T. Higgins, Collector, Appellant,* and that said judgment of the United States Circuit Court of Appeals for the Second Circuit may be reviewed by this honorable Court and that your petitioner may have such other and

further relief in the premises as to this honorable Court may seem meet and just.

Dated: New York, April 30, 1947.

HELEN A. DEGUIRE,

By JOHN P. MCGRATH,
Attorney for Petitioner.

EASTERN DISTRICT OF NEW YORK,
COUNTY OF KINGS, *ss.*:

I hereby certify that I have examined the foregoing petition for a writ of certiorari and that, in my opinion, it is well founded and the cause is one in which the petition should be granted.

JOHN P. MCGRATH,
Attorney for Petitioner.

Supreme Court of the United States

October Term—1946

HELEN A. DEGUIRE, as Executrix of the Last Will and Testament of George N. DeGuire, deceased,

Petitioner,

—against—

JOSEPH T. HIGGINS, Collector of Internal Revenue of the United States for the Third District of New York,

Respondent.

BRIEF IN SUPPORT OF APPLICATION FOR WRIT

Opinions in the Courts Below

The opinion of the District Court reported in 65 F. Supp. 445, is printed in the record at page 123, and the opinion of the Circuit Court reported in 159 F. 2d 921, is printed at page 134 of the record.

Jurisdiction

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code (28 U. S. C. A., sec. 347 (a)). The order for mandate herein was entered on February 11, 1947.

Statement of the Case

This has been set forth generally in the foregoing petition. Further specific facts are developed in the appropriate points of this brief.

Specification of Errors

1. The Circuit Court erred in holding that the benefit to the buyer was an income benefit, rather than a capital benefit, and was taxable as such.

2. The Circuit Court erred in holding that the entire dividend was taxable as income for 1936, for even if held to be an income benefit, only the net benefit was required to be reported.

Statutes Involved

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> "Sec. 22. Gross Income.
>
> (a) General Definition.—'*Gross Income' includes* gains, profits, and *income derived from* salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trade, businesses, commerce, or *sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property;* also from interest, rent, *dividends,* securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *" (Italics ours.)

Section 275 of the Revenue Act of 1936 provides in part:

"(a) General Rule. The amount of income taxes imposed by this title shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

(c) Omission from gross income. If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed."

Summary of Argument

1). The agreement effectuated a reduction in the purchase price by the amount of dividends paid to the sellers. Therefore, any benefit to the purchaser, under the agreement was a capital benefit and cannot be taxable as income.

2). The assessment of a deficiency for the year 1936 is barred by the three year Statute of Limitations.

POINT I

The Circuit Court erred in holding that the benefit to the buyer was an income benefit, rather than a capital benefit, and was taxable as such.

Both the District Court below (126) and the Board of Tax Appeals in *Moore* v. *Commissioner,* 42 B. T. A. 949, following the principle of *Viault* v. *Commissioner,* 36 B. T. A. 430, held that what DeGuire got through the credit of dividends on the purchase price was simply a reduction in the purchase price of the stock; that he did not receive the dividends as such. We submit that such a reduction in price was precisely what the parties intended and accomplished. And, according to the law of Illinois, it is the intention of the parties that controls (126).

The evidence discloses that before the signing of the formal agreement the parties had expressed various ideas as to what the agreement should provide with respect to the payment of dividends, immediately and during the life of the agreement.

On November 8, 1935, two of the stockholders, Moore and Bosworth, wrote:

> "If sale is made before the payment of the dividend recently declared, I am willing the dividend to me be applied on the cash payment, * * *"

They also insisted, at that time, that no further dividends should be declared or paid until the notes were paid (57, 58).

In his letter of December 2, 1935, to DeGuire, Lee, the attorney for Moore, made a counter-proposal to DeGuire's

offer of November 14, 1935, to which he added a postscript reading:

> "The recent dividend would be deducted from above figures as per agreement" (47).

In DeGuire's letter of December 21, 1935, to Lee, DeGuire offered $150,000 for 6,000 shares, less the $6,000 dividend recently declared and paid, the $6,000 to be deducted from the cash payment (48, 49). Again, on December 26, 1935, DeGuire wrote to Lee offering $156,001, less the dividend recently declared and paid, and expressed his willingness that dividends declared and paid on the stock during the life of the agreement should be credited on the face amount of the unpaid notes (52, 53). This offer was accepted and constituted the final agreement of the parties as to price.

These preliminary negotiations, with respect to the treatment of the recently declared $6,000 dividend, plainly show that the parties distinctly had in mind an adjustment of the purchase price through the application of the dividends, and that they planned to utilize for that purpose not only prospective dividends but dividends theretofore declared, as well. They were definitely aware of the fact that the immediate and potential value of stock, depending upon whether sold with or without dividends, directly affects the price a purchaser is willing to pay (see *Estate of Putnam* v. *Commissioner*, 324 U. S. 393, 400).

At the conclusion of the preliminary negotiations the price DeGuire agreed to pay Mrs. Moore for her stock was $25 a share for 4,000 shares or a total of $100,000 (45-53). But the formal contract does not stipulate the price to be $100,000; it calls on DeGuire to pay only $96,000 to Mrs. Moore for her 4,000 shares; this is only $24 a share, not $25. What the draftsman of the agreement did was to first de-

duct the recently declared $4,000 dividend from the stipulated price of $100,000, thereby reducing that price of $100,000 to $96,000 and then he incorporated only the $96,000 figure in the written agreement (12, 13). This fact seems to have escaped the Circuit Court below (135).

Hence, from the very inception, the parties, by their own practical construction of their agreement, commenced to reduce the price by the application of dividends. $100,000 less $4,000 resulting in $96,000 certainly constituted an initial reduction in the selling price and, of course, that $4,000 was taxable to Mrs. Moore. It is obvious that the parties intended to treat future dividends in precisely the same way.

As the District Court pointed out:

> "DeGuire had no beneficial interest in the dividend or the proceeds of the corporation's check for it. * * * What DeGuire got was a reduction in the price of the stock in a company whose assets had been correspondingly depleted. The credit allowed him on the purchase price would have been an element in determining its cost but that is its only effect. Taxes are imposed on gains. We can discern no gain received by DeGuire in the transaction and assessing and collecting *an income tax* for his part in buying the Ajax stock was done in error" (126, italics ours).

It follows that DeGuire's cost basis for the stock was lessened and as to him the tax would fall on any capital gain he might realize.

The taxation of interim income from property held in escrow was considered in Harvard Law Review (LIX, 8, October, 1946), p. 1292 at p. 1298:

> "In setting up an escrow arrangement involving the transfer of income-producing property, the contract

will typically provide in one of two ways for the disposition of such income. In one case, the income will be accumulated by the escrow agent and paid over to the buyer together with the property itself on the happening of the contingency.[41] In the other, the income is paid over to the seller as it is received by the escrow agent, such payments going to reduce the purchase price otherwise payable by the buyer. In the first case, the buyer is, of course, held taxable.[42] In dealing with the second case, the decisions have held the income to be taxable to the 'owner' of the property.[43] This has resulted in taxation to the seller. An accounting analysis of the result of paying the income to the seller indicates that the economic benefit of the income inures to the buyer, since his liabilities are decreased without a corresponding decrease in assets. The seller's increase in assets, on the other hand, is balanced by a decrease in his claim against the buyer. *But if the buyer's obligation is fixed at a higher amount than it would otherwise have been because of anticipation of*

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41 If the income is to be paid to the buyer as it is received by the escrow agent, it seems clear that the buyer is taxable thereon. Philip W. McAbee, 5 T. C. No. 140 (Nov. 28, 1945). A question was formerly raised under Section 25 (a) (1) of the Revenue Act of 1934 as to whether interim dividends on stock held in escrow subject to employee purchase were deductible for normal tax purposes under that section or were to be regarded as compensation. The decisions indicate that technical ownership of shares was required to constitute the employee a shareholder within Section 115(a) of the Revenue Act of 1934 defining 'dividends'. *Compare* Chaplin v. Commissioner, 136 F. (2d) 298 (C. C. A. 9th, 1943) (dividends), *with* Roscoe H. Aldrich, 3 B. T. A. 911 (1926) (compensation).

42 Chaplin v. Commissioner, 316 F. (2d) 298 (C. C. A. 9th, 1943); Philip W. McAbee, 5 T. C. No. 140 (Nov. 28, 1945).

43 George R. Myers, 42 B. T. A. 640 (1940); Max Viault, 36 B. T. A. 430 (1937); see I. T. 1958, III-1 Cum. Bull. 111 (1924). *But cf.* Moore v. Commissioner, 124 F. (2d) 991 (C. C. A. 7th, 1941).

> *this interim income, it is fair to consider the income as a benefit to the seller insofar as he has received a gain on the whole transaction.*" And the possibility of using the device to avoid taxation of income to the owner of the income-producing property would also seem to justify taxation to the seller.[45] " (Italics ours.)

The same article, referring specifically to the instant agreement, concludes with the statement:

> "Such divergent results, reached on the same facts through nice constructions of the contract involved, indicate the desirability of a settled rule. Taxation to the seller alone would seem sufficient to prevent any unwarranted avoidance of tax by deflection of income and would be reasonably in accord with the economic benefits conferred by the transaction" (p. 1299).

It may be argued that the payment of interim dividends did not necessarily deplete the assets of this corporation, *as of the date of the contract,* for the dividends might be paid, not from surplus but from current earnings. Payment of dividends from the then surplus or from current earnings would be a depletion of the assets of the corporation, in any event, for, in fixing the purchase price, DeGuire included a liberal allowance for good will (50). Having fixed a price which included not only book value but good will, that is, the capitalized value of the corporation's future earnings (*Metropolitan Bank* v. *St. Louis Dispatch Co.,* 149 U. S. 436; *Von Au* v. *Magenheimer,* 115 App. Div.

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44 The decisions do not make this refinement, however, and the seller is taxed on the entire interim income. Max Viault, 36 B. T. A. 430 (1937); see I. T. 1958, III-1 Cum. Bull. 111 (1924).

45 *Cf.* Reginald B. Parsons, 44 B. T. A. 1142 (1941).

[N. Y.] 84), it was but logical for the parties to provide for a downward adjustment of the price when a portion of what DeGuire had offered to buy was withdrawn from the corporation before title vested in him.

It was clearly within the contemplation of the parties, at the time the agreement was made, that the future distribution of a dividend to Mrs. Moore would necessarily result in reducing *pro tanto* the value of the stock which would ultimately come into the hands of DeGuire as the purchaser (see Editorials, New York Law Journal, January 21, 22 and 23, 1946).

With this prospect in view, DeGuire, while willing to agree to accept the stock at its future lessened value, as reduced by the distribution of dividends, was willing to do so only on condition that the contract at the same time stipulate that all such future dividends should be "credited by the recipient thereof upon the selling price" (16). This was, undoubtedly, conceived by Mrs. Moore's attorney, the draftsman of the formal agreement, as a simple method of adjusting the sales price downward in strict accord with the dividends which might later be distributed, and to compensate the purchaser for the decrease in the value of the stock he would ultimately receive. Thus, there was worked out between Mrs. Moore and Mr. DeGuire a reasonable *quid pro quo* in that whereas under the agreement Mrs. Moore was, during the life of the agreement, to receive the dividends *qua* dividends, DeGuire, by reason of the resulting decrease in the value of the stock, was to receive a credit in the amount of the dividends so distributed to Mrs. Moore on the selling price of the stock.

Moreover, since DeGuire, under the contract, was never under any personal obligation to pay any of the promissory notes, or even the interest thereon (16, 17, 18), it is plain that the formality of crediting the amount of the dividends

on the selling price did not signify a discharge of any debt of DeGuire's. Looked at realistically, it amounted to nothing more than a reduction of the amount of the selling price to offset the reduction in a capital asset, *i.e.*, the stock by reason of the dividend distribution.

It seems clear, therefore, that DeGuire engaged in a capital transaction which had no income aspect to him; he received no income benefit taxable as such. He did receive an abatement in the purchase price of the stock, a capital benefit which becomes taxable when a capital gain is realized on the sale of the stock.

That DeGuire received some benefit from the transaction is undeniable, but it is erroneous to say that he received an income benefit.

POINT II

The Circuit Court erred in holding that the entire dividend was taxable as income for 1936, for even if held to be an income benefit, only the net benefit from the contract was required to be reported as a taxable item.

The Circuit Court reversed the District Court and upheld the assessment of the income tax on the dividends against DeGuire on the theory that even though he was not the owner of the stock, he received the benefit of the dividends. The concurring opinion sustained the tax against him on the ground that he held the greater number of a "bundle" of rights with regard to the stock. There was a complete failure to distinguish between benefits taxable as income and benefits taxable under the revenue laws relating to capital gains.

Even if we assume that the benefit to DeGuire was taxable as income, the net benefit only, that is, the dividends less the interest on the purchase price, was required to be reported as a taxable item. Any benefit DeGuire received from the dividends, flowed from and were received by virtue of the agreement to sell the stock. As the dividends were applied in reduction of the purchase price (the sole benefit to DeGuire), they were burdened with the interest which the unpaid balance of the purchase price carried and the net benefit received by DeGuire was the amount of the dividends less the interest. It matters not whether the interest be computed on the unpaid balance of the purchase price or on the amount of the dividends for, in either event, the net benefit was less than 25 percent of the gross income stated in the return.

The deficiency for the year 1936 was assessed against DeGuire under I. R. C. 275, subd. 3, on the theory that the taxpayer omitted from gross income an amount in excess of 25 percent of the gross income stated in the return and hence the five year Statute of Limitations applies. If the dividends are taxable to DeGuire "*qua* dividends", then he failed to include the gross amount of dividends and the contention of the Collector is correct. If, however, the burdens are set off against the benefits and the tax is assessed against the net benefit from the contract, the three year statute applies, and the assessment of the deficiency is barred by the Statute of Limitations. But under no view of the case can it be successfully contended that the dividends are taxable to DeGuire "*qua* dividends". In order for the dividends to be taxable to DeGuire "*qua* dividends", DeGuire must have been the owner of the stock at the time the dividends were declared and paid. If the assessment of the tax on the dividends against DeGuire is to be sustained at all, it can only be upon some theory of beneficial

use or enjoyment. And that, plainly, would be the precise net benefit derived from the contract.

If DeGuire is to be charged with income tax because he received "the actual benefit for which the tax is paid" (*Griffiths* v. *Commissioner*, 308 U. S. 355, 357), then surely the benefit taxable to him is not taxable "*qua* dividends", but is taxable solely because the contract for the sale of the stock provides that any dividends paid are to be credited on account of the principal and interest on the notes representing the balance of the purchase price. Such taxation of DeGuire would only be upon the net benefit derived by him under the agreement to sell the stock.

The holding here was not that DeGuire actually *received* dividends, *qua* dividends, but that he derived an "actual benefit" through the crediting of the dividends on the purchase price of the stock, pursuant to the provisions of the contract. In the absence of that agreement, there would be no basis for asserting any tax liability against DeGuire; hence such tax liability as may exist by virtue of that agreement must be limited to the benefits which ultimately flowed to him by reason thereof. Its benefits cannot be freed of its burdens and a tax imposed on the benefits in disregard of the burdens. The taxable income to DeGuire, if any, must be deemed to be the residuum of benefit after the burdens have been offset.

The statute defining "gross income" does not expressly include "actual benefit"; that is language read into the statute by judicial construction. The statute (Revenue Act of 1936, c. 690, 49 Stat. 1648, Sec. 22), defining gross income, includes "dividends" as a distinct category of gross income. As so included, such "dividends" can only refer to dividends received by the taxpayer, precisely as divi-

dends. In the same statute, but in a separate clause we find:

> "• • • *income derived* from • • • sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; • • •"

listed as a separate category of gross income.

The dividends amounted to $34,895, but the interest which had accrued upon the notes at 5 per cent per annum, up to the date that the dividends were credited to DeGuire, amounted to $3,498.36 (60, 61, 63). The sum total of benefit that could possibly be realized by DeGuire under the contract of sale is the difference between these two figures, $31,396.64, which is the maximum amount that DeGuire could have been obliged to report as income.

Assuming, therefore, that DeGuire wrongfully failed to report this sum of $31,396.64 on his 1936 return, this amount is less than 25 per cent of the amount actually reported of $137,683.47, and the three year Statute of Limitations applies.

The Collector asserts that, in the first instance, the gross amount of dividends, $34,895., should have been reported by DeGuire precisely as dividends, and then, later, a deduction taken for the interest of $3,498.36 paid on the notes. The effect of this would be that the taxpayer omitted from gross income the gross amount of dividends, $34,895, which is in excess of 25 per cent of $137,683.47, the gross income reported, and, therefore, the five-year statute would apply.

The Internal Revenue Code does not support this argument. Interest paid by DeGuire on the notes would not be a deductible item under the statute (see ***Deputy*** v. ***du Pont,***

308 U. S. 488, 497). Section 23 (b) provides that in computing net income there shall be allowed as deductions:

> "(b) Interest.—All interest paid or accrued within the taxable year on *indebtedness,* * * *."

Hence, before interest can be deducted, it must be shown to have been paid or to have accrued on a debt of the taxpayer. But here the taxpayer was not indebted to anyone. By the express terms of the contract, DeGuire was absolutely relieved of all indebtedness for interest as well as for the principal of the notes (16-18).

In this connection, two facts stand out clearly: (1) that DeGuire did not actually *receive* the dividends of $34,895 and, therefore, such amount cannot be taxed against him "*qua* dividends"; and (2) that DeGuire, in the year 1936, did in fact pay interest of $3,498.36 on the notes, in partial exercise of his option, but not under compulsion of any indebtedness as a result of which he might claim a deduction of $3,498.36 for interest paid on "*indebtedness.*"

The 1936 income tax form (109), under "Income" on page 1, provides for a statement of "Other Income", as item 11 "(Use separate schedule, if necessary)". That is precisely the place where income derived through a contract on the theory of benefit should be reported, and not, for the reasons stated, under item 6 "Dividends" with a later deduction for "Interest paid" under item 13.

If the statute, in defining "gross income" as including "*gains, profits, and income derived from* * * *sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property;* * * *" (Sec. 22a), was not intended to cover this specific type of transaction, then it is surely covered by the subsequent all-inclusive language "or gains, profits and income derived

from any source whatever" (*id.*). It is this section of the Internal Revenue Code (22) that has been construed as conferring the right to tax upon the theory of beneficial use or enjoyment. But, under a contract, benefit cannot be divorced from detriment, and the ultimate benefit derived through a contractual relationship is the resultant remainder after the losses have been set off against the gains. Such ultimate benefit is the only figure required to be reported for income tax purposes.

CONCLUSION

It is respectfully submitted that the petition for a Writ should be granted.

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